Allocation of Cooperative Earnings

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The allocation of earnings by cooperatives has attracted much attention recently. A study in 1977 by U.S.D.A's Economics, Statistics and Cooperative Service found that 29% of marketing and supply cooperatives had no equity redemption plan. In 1978 the General Accounting Office, an arm of Congress, studied a sample of farmer cooperatives and their members and reached nearly the same conclusion. The increase in prime interest rates encourages some cooperatives to seek ways of increasing equity dividends only to discover that if they were not 521 cooperatives the payment of high stock dividends plus IRS taxes on these dividends put a financial strain on the cooperative. Thus, there has been an increased interest in the subject of cooperative financing and allocation of earnings.

The unique features of a cooperative are reflected in the financial structure of a cooperative. These unique cooperative features are found in the five basic features that differentiate cooperatives from the other three types of businesses that operate in our free competitive economy: (1) Financed by members, (2) Limited return on equity capital, (3) Operations at cost, (4) Education of members about the cooperative way of doing business and (5) Democratic control.[1/] Using these principles cooperatives can usually capitalize themselves.

Please recognize that my remarks pertain to the cooperative corporation rather than the investor corporation, the partnership or the sole proprietorship

Why should anyone ask the rather academic question--what is a cooperative? Because courts ask the question, state and Federal law enforcement officials ask

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[1/] The Principles of Cooperatives, C. H. Ingraham, Department of Agricultural Economics and Rural Sociology, The College of Agriculture, The Ohio State University, ESO 655.

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the question, lawmakers ask the question and farmers ask the question. Because they ask the question, we must also ask it, and you must be prepared to at least communicate your understanding of cooperatives.

A cooperative is a capitalistic venture. A cooperative uses capital to make a profit. A major difference between the cooperative and the investor corporation is that the cooperative corporation employs the price adjustment theory and distributes its net savings or margins (profits) to patrons as they are overcharges of items sold to patrons or underpayments for goods sold by patrons. Investor corporations distribute their profits as dividends to investors. On occasions, I hear statements such as "cooperatives are like any other business -- the cooperative principles are out-of-date and no longer apply -- the cooperative principles must change -- it's our monev (the margins of the cooperative) and we can do with it as we please -- cooperatives are like all other businesses." All of us in this room have had our academic training based on primarily investor corporations. For some it is a difficult task to change our thinking from Return on Investment to Value Added or to the price adjustment theory.

So, what is a cooperative? It is one of the four ways of doing business that the people of the United States - society - has permitted to operate in our free competitive economy.

To briefly describe the four ways of doing business---A sole propritorship is a business owned and managed by one person. The partnership is a business where two or more persons are co-owners of a business for profit of the partners. An investor corporation is a business where people invest their money in anticipation of receiving a return (profit) on their investment. The cooperative corporation is an extension of its members' business - a cooperative is a firm carrying on the business of its members. In a cooperative persons do not benefit by receiving a return on their investment but benefit from the value added to the goods and services resulting from their primary business, such as farming, thus increasing their profits from their farming operation.

John Holt, Director, Corporate Tax Division, Internal Revenue Service, authored an article that appeared in the Spring 1976 issue of The Cooperative Accountant. I want to share with you a few quotes from that article.

> "This is based on the principle that the cooperative is acting as a type of conduit in doing the patrons' business, and that the cooperative's transaction is really the patron's transaction. Therefore, there should not be a tax levied more than once since there was only one transaction. This places the cooperative in an agency, trust, fiduciary or conduit role, however one cares to try and define the relationship. The fact and theory merge in that the cooperative is not entitled to entity ownership of the results of the business. These results belong to the patrons on the basis of their patronage, a pre-existing legal obligation. Thus, we do not have a separate taxable organization carrying on a 'for profit business' that we should tax apart from its ownership"[2/]

"What then, is a cooperative? What does it mean to be organized and operated on a cooperative basis within the meaning of section 521, or to be operated as a cooperative within the meaning of subchapter T with respect to nonexempt cooperatives. In dealing with the cooperative concept the major problem is that of distinguishing between the proper characteristics of a cooperative, and the more normal ones that we associate with those organizations taxable as commerical "for profit" corporations. Conceptually, a cooperative may be viewed as merely a servicing (management) or clearing house organization carrying on the business of its

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[2/] Income Taxes--Farmer's Cooperatives--Some Concepts, John W. Holt, Director Corporation Tax Division, Internal Revenue Service, The Cooperative Accountant, Spring, 1976, pages 2-14.

members. Certainly, once a cooperative takes title to patronage margins or losses in its own right, it passes beyond the cooperative status into a for-profit operation status. This difference was made clear in the 1941 PEOPLES GIN COMPANY CASE and in SMITH AND WIGGINS GIN, INC., a 1965 opinion of United States Court of Appeals for the Fifth Circuit. These cases focus on the distinction between a patronage distribution and a dividend distribution. The former represents amounts which never vested, as such, in the entity or its at-risk owners. The latter represents entity profits distributed after such vesting. What is true for profits presumably must also be true for losses, particularly in situations where patronage losses are attributable to an initial over advance, since patronage margins are attributable, in a sense, to initial under advances".2/

"Similarly, a cooperative organization must distribute margins on the basis of patronage, not on the basis of capital investment. Of course the patronage dividends must be paid pursuant to a pre-existing legal obligation and provisions that provide for payment "as and when declared by the directors" would have the effect of obviating the mutuality of the organization. Another factor is that dealings between the cooperative and its members may not be weighted in favor of a given group so that the concept of operation at cost is obviated. Thus, the operation at cost principle must be carried out under an overriding concept of equitable allocation of net margins.2/

"While the subordination of capital with respect to the control of a cooperative (democratic control) has been discussed as a basic principle, so also is subordination of capital, with respect to ownership, a controlling concept. Not only must the patrons of a cooperative be in control, but they must also own its capital. This is capital in an equity or retained profit sense. The emphasis here has been on limitations on the amount of capital any individual may invest, and limitations on the return on that capital, or both. Section 521 recognizes these restrictions by limiting the rate of return on capital stock. Section 521(b) adds an additional requirement that "substantially all" of such stock be "owned by producers who market their products or purchase their supplies and equipment through the association.[2/]

"In COOPERATIVE GRAIN AND SUPPLY CO. the court rejected the concept of membership if the member patronized the cooperative "only at such times as producers may determine that it is expedient for them to do so." Where the owners of the investment capital are not members at all, or retain membership only as a formality and do not actively patronize the organization, the subordination of capital argument gains substantial weight. The concept encompasses priorities given to investment capital with respect to dividends or to assets upon liquidation.[2/]

Annually, the results of the cooperative corporation's activities are determined through accounting principles similar to those of an investor corporation and the margins or net savings are determined. In the cooperative corporation margins or net savings are equivalent to profits in an investor corporation. These net saving provide part of the cash flow needed to service debt, service equity and provide for future growth. For our discussion today let's assume that these net savings or margins are allocated to each patron on the basis of hit patronage. This allocation is called patronage refund. The patronage refund when allocated is simply a price adjustment. The patronage refund is an additional amount that should be paid to the patron for his products. To the patron the patronage refund is that amount, that in a perfect cooperative operation, which would have been paid him at the time of the sale, and the amount of the patronage refund must, therefore, be added to his other realized income and taxed by IRS.

There is an alternate method called pooling that is used by many marketing cooperatives. The producer usually has a contract to deliver products to his cooperative at a price. A predetermined amount is deducted for each unit delivered for the cost of marketing. This is called "per unit retain." Pooling operations return all proceeds, less operating costs, to patrons and generally show zero margins. Cash flow is generated through capital retains deducted from payments to growers.

The procedures for the computation and allocation of a cooperative's net savings or margins is set forth in its Articles of Incorporation, Bylaws, or membership contracts. In all cases they must be paid pursuant to a preexisting legal obligation.

The Revenue Act of 1962 provided a systematic way that cooperatives might use to meet the basic principle of Financed by Members.

All organizations qualifying under Subchapter T are permitted to deduct, for purposes of income taxation, amounts paid out as patronage refunds and per unit retain allocations, provided these payments meet the definition of such in the law. One method of allocation is qualified written notices of allocation. "A qualified notice of allocation or per unit retain certificate is a document which the distributee has consented to accept as income at its stated dollar amount. In the case of a "qualifed" notice of patronage dividend, at least 20 percent of the total amount must be paid in cash or with a qualified check.[3/]

The basic cooperative principle - Operations at Cost - comes into play, when it is determined where the margins of the cooperative go. If this were an investor corporation there would be profits and the profits would be distributed as returns on investment. The directors or trustees have the responsibility for the allocation of the cooperative's margins. They must, of course, make this decision within the requirements set forth in the Articles of Incorporation, Bylaws or membership contracts.

Although the terminology is not precise, I will refer to price adjustment as a "patronage refund". If the cooperative is to operate at cost and return all

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[3/] Ingraham, Hollis, Conklin, Federal Income Taxation of Farmer Cooperatives, Cooperative Extension Service, College of Agriculture, The Ohio State University, Bulletin 519 (Revised 1978).

margins to the patrons, the patronage refund will be paid out 100% in cash. This, however, would leave the cooperative with zero cash flows from earnings. Because of the need to generate cash flows, cooperatives will usually pay part of the patronage refund in cash and retain the remainder as equity. Tax laws require a minimum 20% of the patronage refund be paid to the patron in cash. The patron, however, pays income tax on both the cash and the non-cash patronage refund. The patron receives the non-cash portion of the patronage refund in some future year when equities are revolved. The final price adjustment to the patron is the cash pagronage refund, less income tax paid on the cash and non-cash patronage refund, plus the "present value" of the non-cash refund.[4/]

The length of revolvement or the retirement period for the non-cash patronage refund is important when measuring the final price adjustment. The longer the retirement period, the lower the present value of the non-cash refund or capital retain. Past patrons of the cooperative realize the time value of money and will often press for a shorter retirement period. On the other hand, current patrons will press for a higher cash refund on current patronage. Given the cash flow constraint faced by most cooperatives, payment of more cash in the current year, or assessing a lower capital retain will mean a longer revolving period. In reality, cooperative performance is constrained by cash flow requirements to service debt, service equity and to provide for future growth.[4/]

Two points can then be made on how operation at cost uniquely impacts a cooperative. First, operation at cost does not mean the same as zero cash flow. Second, operation at cost can create a membership division into current patrons and past patrons.[4/]

A poor record of revolving or retiring equities generated by non-cash patronage is related to the cooperative principle of democratic control. This principle

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[4/] Richard Fenwick, Vice President, Central Bank for Cooperatives, Denver, Colorado, Cooperative Principles and Finance, Proceedings AIC Employee and Collegiate Seminar, University of Missouri-Columbia, August 6, 1979.

assures that control and ownership are kept in the hands of current patrons. When equities generated by non-cash patronage are not retired, or are revolved slowly, control and financial support will not be in proportion to current patronage of the cooperative. This issue also relates to a cooperative concept that services will be performed or products sold, not for the general public, but for those who own and control the cooperative. The resulting problem is: if those who are to benefit from the cooperative do not own and control the business, benefits may not accure to others than patrons. Inactive members then can become a serious problem, halting capital formation and limiting future growth for both margin and pool cooperatives.[4/]

Inactive members of margin cooperatives are often anxious to charge higher prices, pay out a minimum 20% cash, halt capital expenditures, and excelerate the retirement of equity that resulted from non-cash patronage. This increases performance of the cooperative as far as inactive members are concerned. On the other hand, current patrons are sure that performance will be enhanced by charging lower prices or paying out a larger proportion of current earnings in cash patronage at the expense of equity retirement. Inactive members of pool cooperatives are interested in high current capital retains and the revolvement of equity capital. The current patrons want to see low capital retains and limited equity retirement.[4/]

The cooperative principle - limited returns on equity capital, also impacts the ability of a cooperative to capitalize itself. The impact can be felt two ways. First, a limited return on equity capital diminishes the incentive for a patron to make an initial or additional cash investment in a cooperative. In addition, since each member generally has one vote (democratic control), there is no control advantage to be gained through stock accumulation. This further complicates the sale of stock or other equity certificates to members or non-members.[4/]

Let's take a look at some options that directors may want to consider. First, we must keep in mind that one of the responsibilities of the directors is to protect the economic well being of the cooperative corporation.

The cooperative's net savings can be allocated as patronage refunds. This can be made in money, property or qualified written notice of allocation. The director must decide which of these three methods is best for the individual cooperative.

As pointed out previously, the qualified written notice of allocation is a way that the basic principle - Financed by Members - can be met. This method of meeting the basic principle of - Operations at Cost - can in the future be classified as cash and non-cash patronage. Cash patronage refunds are those funds that are returned to patrons in cash or qualified check to meet the requirement that 20 percent of all allocated patronage refunds must be distributed in cash. Non-cash patronage refunds are that portion of patronage refunds which becomes the patron's equity in his cooperative.

The board of directors are often under pressure by members to pay a greater amount than 20% of the patronage refund in the cash portion. Here is where another basic cooperative principle comes into the picture, the principle of Duty to Education members about the cooperative way of doing business. While the 1962 Revenue Act provided this logical way for the patrons to finance their cooperative by using the non-cash portion of their patronage refund, it reduced the necessity for directors to contact patrons for out-of-the-pocket contributions to the firms equity capital requirements, these personal requests were, of course, supported by the directors explaining the operation of and the uniqueness of the cooperative way of doing business.

Farmers must finance their cooperative. This is a major requirement for successful cooperative enterprise. It is also a source of much legal contention.[5/]

It is evident that the cooperative's net margin dollar can only be spent once by the directors. In this case every dollar over the 20% minimum required cash patronage is one dollar less equity the patron has in the cooperative.

Another challenging decision for many boards of directors and members is the amount of dividends to pay on equity capital. In Ohio for those firms incorporated under section 1729 the maximu, dividend rate is still 8%. This, of course, reflects the basic cooperative principle of 'limited returns on equity capital' which assures patrons that the net savings of the cooperative will not be distributed to investors and also supplements the basic principle of 'financed by members' by discouraging speculative investments in the cooperative's equity capital and necessitates the principle of 'educating members'. I assume that you all know this applies to equity capital, and that you know equity capital from debt capital. Debt capital has a due date.

Another important area to consider is whether an association is organized with or without capital stock. Since '521' associations dividends can be deducted from taxable income and the nonexempt cooperatives cannot, 521 status offers an advantage to associations organized with capital stock. Neither tax status offers an advantage in this area to a nonstock cooperative.

A 521 association paying dividends on equity capital receives a dollar for dollar reduction before IRS taxable income. For a nonexempt or non-521 association to pay the same amount of dividends on equity capital its before tax income

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[5/] Cooperative Principles and The Law. Dr. James R. Baarda, Agricultural Economist, Cooperative Management Division, Economics, Statistics and Cooperative Service, U.S.D.A. Proceedings of Employee and Collegiate Seminar, American Institute of Cooperation, 1979.

would need to be much greater. The economic advantage of the deduction for dividends on equity capital can be expressed by this formula: [Stock Dividends Paid ÷ (1 - tax rate)] - Stock Dividend Paid = Additional Income Needed by Nonexempt Association to Pay The Same Amount of Dividend On Stock.

Example: [$10,000 ÷ (1 - .46] - $10,000 = $8,518.51 A stock dividend of $10,000 and a tax rate of 46% gives an economic advantage of $8,518.51 for a Section 521 or "exempt" status association.[6/]

The taxation of dividends has caused the members of some non-521 cooperatives to seriously consider the payment of no dividends on equity capital. Let's consider the previous example - $10,000 stock dividends plus $8,518.51 for IRS makes a total of $18,518.51.

Assume the principle - Financed by Members, is being followed. Had this $18,518.51 been allocated as patronage refunds, patrons would have $18,518.51 additional income. If the minimum of 20% were paid as cash patronage and 80% non-cash member equity in the cooperative would be increased by $14,814.80. This compares $18,518.51 vs $0 for patrons income; $14,814.80 vs $0 for patrons equity in the cooperative; $10,000 vs $0 as return on invested capital.

Let us assume that this same $18,518.51 was to be allocated to redeem old non-cash patronage. In this situation the entire $18,518.51 could be placed in the hands of patrons as tax paid income, the income tax having been paid by the patron in the year allocated. This action would also result in a decrease of $18,518.51 in the cooperative equity capital.

There are a variety of ways cooperatives can calculate patronage refunds. Some cooperatives have found qualified allocations to be advantageous. Thus, it is difficult to say all cooperative should follow a particular course.

I like to use as my guide - "What's Best for Patrons".

[6/] Ingraham, Hollis, Conklin. Selecting the Federal Tax Status for Farmer Cooperatives, Cooperative Extension Service, College of Agriculture, The Ohio State University, Bulletin 519 (Revised 1978), page 3.